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To The Files
From James A. Hecker
Date August 21, 2001
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Yesterday I received an ostensibly social call from Sherron Smith Watkins, a Houston office alum who works in the CFO's group at our large audit client, Enron. After some small talk about current events such as the job market and last week's CEO resignation at Enron, she asked me if I knew much about some of Enron's recent structured transactions. I told her I did not, having never worked on the Enron job, but that I had general knowledge about many of the related issues from my work on other marketing and trading clients. Although she seemed initially reluctant to get into the details with me, an Arthur Andersen audit partner, she obviously wanted a "sounding board" with whom she could discuss certain of her concerns related to a set of Enron transactions, and I told her I'd be happy to listen.

Sherron then told me she was concerned about the propriety of accounting for certain related-party transactions. The transactions in question were, based on our discussions, with an entity with a name something like "LJM", which was at the time of the transactions at least partly owned by Andy Fastow, Enron's CFO (and her current boss). She later told me that Fastow's interest in "LJM" has since been sold to Michael Copper, an Enron alum. I also understood by her tone that the potentially sensitive transactions were done within the last couple of years. Sherron seemed even more agitated about the transactions' accounting because she perceived the related footnote disclosures in the company's consolidated financial statements were difficult to understand and did not tell the "whole story."

After some investigative work since her return to Fastow's group, she reportedly had discussed some of her concerns with Enron's general counsel office (she did not name the individual). That individual had assured her that AA and Enron's external counsel (Vinson & Elkins) had reviewed the transactions' accounting and financial statement disclosures and that they were sure there was no impropriety. At that point, I mentioned to Sherron that many people inside and outside the company assume we have seen every small transaction and OK'd the accounting, which for many reasons, potentially including immateriality, is often not true. Sherron understood this, but assured me the dollars involved (approximately $500 million) were material, even to (a company as large as) Enron. Based both on the type and size of the transactions, Sherron told me she was concerned enough about these issues that she was going to discuss them with Ken Lay, Enron's Chairman, on Wednesday, August 22, 2001.

Based on our following discussions, her perceptions and concerns were:

- In summary, Sherron couldn't understand how Enron could, with its own capital stock, repeatedly add to the collateral underlying an obligation owed to Enron from a related party without recognizing in its financial statements either a) the related Enron stock distributions or contributions to that related party or b) the high-tech investment losses such related-party obligation was supposedly protecting against.
- LJM, an investment company formerly owned at least partially by Andy Fastow (CFO of Enron), was formed to enter into various structured transactions with Enron. I understood from Sherron that one such transaction involved the hedging of certain of Enron's investments in high-tech companies. Since these high-tech investment values have declined, Enron's hedge from LJM has increased in value, thus putting LJM on the hook for a potentially large liability to Enron. Supporting this hedging arrangement, Sherron described to me that LJM was initially capitalized in large part with Enron stock, which has also significantly declined in value since yearend 2000. Well after LJM's formation, and in response to this resulting reduction in total LJM asset value, her investigative inquiries had pieced together a very troublesome scenario. She perceived that Enron was putting additional Enron stock into LJM (the exact mechanism -- sales, contributions, exchanges or otherwise -- wasn't clear from our conversation), primarily to bolster LJM's perceived ability to repay obligations that will be owed to Enron at some future date. However, according to Sherron, these additional Enron stock contributions/issuances to LJM did not appear to be recorded on Enron's books. I informed Sherron I could not comment because I was obviously unfamiliar with the facts behind both the formation and ongoing operations of LJM.
- She asserted that the Enron financial-statement disclosures related to the Fastow investment-company relationships and transactions were (putting it kindly) hard to understand and incomplete. A $500 million gain from the LJM contract(s) was purportedly identified in interim financial disclosures. However, according to Sherron, it was not clear in the disclosures that the $500 million gain on Enron's books from the Fastow agreement (through LJM) actually offset other losses on Enron's investments in various high-tech investments. The potential collateralization/collectibility issues behind the LJM obligation that Sherron perceived are a problem were also not spelled out. I did not attempt to confirm these disclosure assertions by pulling Enron's Form 10-K or 10-Q's (but see documentation of engagement team discussions below).
- She also asserted that, at the time of the recent sale to Mr. Copper, she had mentioned to others that LJM must have had "very limited" stockholders' equity and must have been an unsuccessful investment for its owner(s). I inferred that she thought Mr. Copper's purchase price must have been relatively small, for one or more of the following reasons: a) LJM owed so much to Enron, or b) the company had so few other assets or c) it only had assets such as Enron stock that had declined so much in value since LJM's inception. However, she also asserted that she had been told that most, if not all, of LJM's equity had been distributed to its shareholder(s) [including Fastow and CIBC, an independent banking organization unrelated to Enron] concurrently, or shortly after, its original formation.

Based on our discussion, I told her she appeared to have some good questions. I emphasized that I was uninvolved in the issues or client and therefore unable to give her any definitive advice or conclusions on

these matters, especially without knowing all the facts, which she understood. However, I encouraged her to discuss these issues with anyone in the company who could satisfy her about the accounting and disclosures related to these transactions. I told her that I admired her "stand-up" attitude and that corporate introspection about these sorts of accounting and reporting issues often was very healthy and should not be suppressed. She neither continued to update me about her discussions with Ken Lay nor requested anything further from me.

Immediately after my discussion with Sherron on August 20, I relayed the essence of her asserted concerns to Bill Swanson (ABA practice director), Dave Duncan (Enron engagement partner) and Deb Cash (a partner on several of the trading segments at Enron). On August 21, we all added Mike Odom, practice director, to the discussions, and agreed to consult with our firm's legal advisor about what actions to take in response to Sherron's discussion of potential accounting and disclosure issues with me.

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